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C O N F I D E N T I A L SECTION 01 OF 03 HONG KONG 001667

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TAGS: EFIN ECON HK CH  
SUBJECT: HONG KONG SEEKS INTEGRATION, EXPECTS RMB  
INTERNATIONALIZATION

REF: A. HONG KONG 1163  
    1B. HONG KONG 880  
    1C. HONG KONG 1280

Classified By: Acting Deputy Principal Officer Martin Murphy, Reason 1.  
4 b/d

11. (C) Summary: In meetings with U.S. Treasury Economic and Financial Emissary David Dollar, Hong Kong financial officials said they do not worry that the Special Administrative Region will be dominated by Shanghai or Guangdong and will continue to pursue closer economic integration and regulatory cooperation with the Mainland. Senior Hong Kong officials believe the Chinese will eventually allow the renminbi to resume appreciation against the dollar, but not until the global economic situation has stabilized. They said the People's Bank of China is reluctant to discuss long-term plans for renminbi internationalization, but believed recent moves to expand the use of renminbi outside of China are clearly part of a strategy to gradually encourage the use of the Chinese Yuan as a reserve currency. Hong Kong's status as an international financial center allows it to play a unique and an important role in international financial organizations, like the Financial Stability Board. Senior Hong Kong officials asked for U.S. support for Hong Kong's continued participation in this body. Hong Kong will pass legislation allowing it to adopt global standards for exchange of tax information by the end of 2009. End Summary.

12. (C) Beijing-based U.S. Treasury Economic and Financial Emissary David Dollar met with Hong Kong government officials, regulators and private investment firms in Hong Kong August 20 to discuss Hong Kong's relationship with Chinese regulators, exchange views on economic performance and financial liberalization in China and Hong Kong, and hear concerns from the Hong Kong government about international financial architecture and regulatory developments. Dollar paid introductory calls on Secretary for Financial Services and the Treasury K.C. Chan and Undersecretary Julia Leung, Sun Jie, Vice President for China at the Hong Kong Securities and Futures Commission (SFC), Peter Pang, Deputy Chief Executive of the Hong Kong Monetary Authority (HKMA), and Morgan Stanley Asia CEO Owen Thomas.

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Nothing to Fear From Closer Integration  
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13. (C) SFC's Sun began by noting that the State Council's March 2009 announcement that Shanghai should become an international financial center has some Hong Kong businesspeople worried that China will favor Shanghai over Hong Kong in future financial liberalization. (reftel A) That fear is unfounded, said Sun. The development of new financial products and Initial Public Offerings (IPOs) in

Shanghai are part of efforts to soak up renminbi (RMB) liquidity in China. As the financial crisis has eased, more Chinese firms are seeking IPOs in Hong Kong and Shanghai. Concerns that Shanghai and Hong Kong are competitors are misplaced, offered Sun. The Chinese economy will continue to grow and there will be plenty of opportunities for both cities. Hong Kong policymakers understand this, he said.

¶ 14. (C) Hong Kong government (HKG) efforts to more closely integrate Hong Kong's economy with the Pearl River Delta have been received coolly by Hong Kong tycoons, said Sun. They worry that Hong Kong will be dominated by Guangdong, given the latter's size and political influence in Beijing. However, the HKG realizes that Guangdong's economic success is important to Hong Kong's real economy. With large numbers of Hong Kong enterprises setting up shop across the border to produce goods and provide services, and large numbers of Guangdong tourists coming to Hong Kong for leisure and shopping, Guangdong's continued economic prosperity directly impacts Hong Kong. The annual revisions to the Closer Economic Partnership Agreements (now on their sixth version --reftel B) freeing cross border trade in goods and services provide valuable opportunities for both sides to benefit from economic integration, said Sun.

¶ 15. (C) Hong Kong/PRC cooperation extends to financial regulatory matters as well. The SFC and the Chinese Securities Regulatory Commission (CSRC) have several exchange programs to bring Chinese regulators to Hong Kong for two weeks to three months at a time. Approximately 50 CSRC staff participate each year, said Sun. Chinese officials have been particularly interested in Hong Kong regulation of fund

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managers and how those regulations are operationalized and enforced. The SFC has been working with regulators in Shenzhen on enforcement issues for several years and Hong Kong and the PRC have an MOU that allows the Hong Kong SFC to participate with Chinese authorities in investigations of Chinese companies.

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HKMA Welcomes S&ED, Doubts Chinese Domestic Demand  
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¶ 16. (C) In discussions with HKMA's Peter Pang, Dollar noted that senior Chinese economic leaders had welcomed the focus on "strategic and high-level" discussions rather than specific policy actions during the recent Strategic and Economic Dialogue meetings in Washington. Pang replied that a broad and frank discussion of both U.S. and Chinese policy objectives is key to addressing global economic imbalances. Both China and the U.S. have important roles to play in the global economic recovery. Chinese fiscal stimulus and the expansion of bank lending have boosted Chinese GDP growth, but it remains unclear whether Chinese efforts to stimulate domestic consumer demand will lead to a longer-term rebalancing of the Chinese economy, he said.

¶ 17. (C) Pang noted that he was pleased to see that RMB valuation did not appear to be a major irritant as in past discussions. He was optimistic that the People's Bank of China (PBOC) would allow additional flexibility in the value of the RMB as the global economy begins to stabilize. The PBOC is reluctant to discuss their long-term plans for RMB internationalization, said Pang. They will start with limited trade settlement now, and will move slowly to expand the scope for RMB outside of China. Since RMB trade settlement was allowed in Hong Kong in early July, only about USD 40 million worth of transactions have taken place, said Pang. Eligibility for the scheme remains limited and unclear, and many Chinese enterprises are not interested in switching to RMB transactions at this time. (reftel C)

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RMB as a Reserve Currency?

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¶18. (C) RMB trade settlement, combined with expanded permission for RMB bond issuance in Hong Kong and RMB currency swaps, are part of a slow process to encourage the eventual use of RMB as a reserve currency. Dollar noted that promoting the Yuan as a reserve currency would require China to run consistent trade deficits, something he doubted was likely anytime soon. China has raised the possibility of the International Monetary Fund including the RMB in its Special Drawing Rights (SDR) unit of accounting. Pang opined that China would like to see the Fund issue SDR bonds, in part to allow countries to diversify their reserves across currencies. China, and Asia in general, deserves a greater voice in the International Financial Institutions, said Pang.

He noted Hong Kong's productive role in the Financial Stability Board (FSB) and the potential that Hong Kong could lose its seat in 2011 under the expansion plan agreed in March 2009. Hong Kong is an international financial center and has a different role to play than that of China, said Pang. He hoped the U.S. would support Hong Kong's continued participation in that body.

¶19. (C) Despite the U.S. economic difficulties, Hong Kong is not considering changing the link between the Hong Kong and U.S. dollars, said Pang. Although the Hong Kong media occasionally raise the question of whether the Hong Kong currency should shift to a RMB peg, the RMB is still no substitute for the U.S. dollar. In addition to the RMBs lack of convertibility, the Hong Kong business cycle is still tied most closely to the U.S. To the degree that Hong Kong's economic cycles are moving closer to China, it is mostly because the Chinese economy is becoming more in tune with the U.S.

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Hong Kong Business Cycle Still Tied to U.S.

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¶10. (C) FSTB Secretary K.C. Chan agreed that Hong Kong's economic cycles are still more closely tied to the United States. He noted that although China has been able to boost government spending in support of continued GDP growth, Hong Kong's relatively large fiscal stimulus packages had only cushioned the downturn. Hong Kong's economy contracted again in Q2 2009 YoY, but the pace of contraction slowed from

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7.8% in Q1 to just 3.2% in Q2. Hong Kong is in for a period of slow growth, predicted Chan, which will mirror the slow growth in the U.S. China's massive fiscal spending and liquidity growth may be fueling asset bubbles, but given the fragile confidence in the economic recovery, asset bubbles may not be bad in the near-term, he said. The real difficulty will be in shifting the Chinese economic model towards domestic demand driven growth.

¶11. (C) Undersecretary Julia Leung offered that Hong Kong is concerned about financial market protectionism, particularly in European markets. Proposed EU rules that would require hedge funds and other financial institutions to maintain a physical presence in countries where they invest are worrying in a global capital market. Leung said U.S. proposals to trade derivatives through a central platform should ensure that non-U.S. regulators also have access to appropriate information. Chan agreed and added that Hong Kong is committed to best practices of international financial regulation. He noted that Hong Kong has played a valuable and active role in the FSB and that Hong Kong will pass legislation allowing it to exchange tax information in accordance with OECD standards by the end of 2009.

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Morgan Stanley Pitches for Financial Market Liberalization

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¶13. (C) Morgan Stanley's Asia CEO Owen Thomas noted that the slow pace of Chinese financial liberalization continues to be a significant frustration for Morgan Stanley. Despite Morgan Stanley's close relationships in China, they have been waiting for several years for a license to offer brokering underwriting services with a new joint venture partner. Allowing futures and derivative trading would encourage additional participation by institutional investors, allow them to hedge their equity bets and reduce volatility, said Thomas. He requested that the U.S. continue to make Chinese financial market liberalization a policy priority.

¶14. (U) David Dollar has cleared this message.  
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